CUMULATIVE EFFECT OF A CHANGE IN ACCOUNTING PRINCIPLE: REMOVE IT FROM THE INCOME STATEMENT

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Abstract:

The comprehensiveness of income, a key definition in accounting, remains contentions despite decades of debate.

A review of this debate reveals that investors have traditionally argued for more comprehensive definitions of income, whereas managers have traditionally argued for less comprehensive measures. We compare performance for both income definitions and component sets. Our results reveal that among income definitions, comprehensive income defined by Statement 130 dominates both traditional net income and fully comprehensive income. No definition dominates clearly.

This, our findings indicate that different definitions of income are more decision useful in different applications and that comprehensive income component disclosures are useful.

Of the two basic approaches to income measurement, the all-inclusive approach has generally been recognized as more useful to financial statement users than the current operating performance approach. The all-inclusive approach requires that all income items flow through the income statement before being closed to retained earnings. In recent years, however, FASB has promulgated several exceptions to the all-inclusive approach, allowing the income effects of certain transactions to be reported directly in owner's equity.

To bring greater awareness to these bypass items ant to aid financial statement users in assessing a firm's activities and the timing and amounts of a firm's future cash flows, SFAS 130 requires firms to disclose comprehensive income.

Comprehensive income consists of traditional net income and the bypass items, called *"other comprehensive income"*. Although firms are expected to apply accounting principles consistently, a firm is allowed to change an accounting principle when justified by economic conditions. When a change in principle is made, the cumulative effect is disclosed on the income statement for most changes, although it is a paper entry with no impact on cash flows or current operating activities.

Moreover, some accounting changes are reflected on the income statement, while others are reported in the retained earnings statement.

Recognizing the *"cumulative effect of accounting changes"* as other comprehensive

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income statement items would both enhance the credibility of net income and provide greater consistency.

Cumulative effect of changes in accounting principle

Companies can change methods of accounting in response to economic or business conditions. The principle under *APB Opinion 20, Accounting Changes,* requires restating the affected balance sheet account to reflect the balance as if the new accounting principle had been used from the beginning; the offsetting debit or credit is reported in the income statement as *the "cumulative effect of a change in accounting principle"*. The cumulative effect is disclosed net of tax and presented as the last line item before net income.

Comparative income statements are not restated using the new principle; the firm must report however pro forma information on income and earnings per share as if the new principle had always been applied.

Exceptions for certain changes in accounting principle

The APB recognized that the cumulative effect of some accounting principle changes could be so large as to skew net income in a misleading wag. Consequently, for certain exceptions, the cumulative effect, net of taxes, does not appear on the income statement. Instead, the cumulative effect is carried directly to retained earnings as an adjustment to the beginning balance. For example, when Chrysler Corporation changed form LIFO to FIFO, the cumulative effect of the change was $ 53.5 million. If the cumulative effect had been disclosed on the income statement instead of the retained earnings statement, Chrysler would have reported a net income of $ 45.9 million instead of a reported net loss of S 7.6 million. In addition, all comparative income statements are restated using the new principle.

The following changes are exceptions that do not appear on the income statement:

1.A change from the LIFO method of inventory pricing;
2.A change in the method of accounting for long-term construction contracts;
3.A change to or from the full cost method in the extractive industries;
4.A change from retirement – replacement – betterment accounting to depreciation accounting. Issuance of financial statements for the first time by a closely held company to obtain equity capital, to effect a business combination, or to register securities.
5.A change to the equity method of accounting for investments.

Another exception is made for a change to LIFO. No cumulative effect is required due to the difficulty, if not impossibility, of such a calculation. The beginning inventory in the year of the change is considered the first layer, and LIFO is applied prospectively.

IASB discussions of an operating/financing classification

During the past few years the IASB and the UK's ASB have been discussing and considering several guiding principles for their joint project on performance reporting.

The Boards of the IASB and ASB agreed that a conceptual approach should be grounded on a primary performance reporting principle, which is:

The investors' perspective suggests that information relating to predicting the rate of change in financial statement items should a primary differentiator between performance statement components.

The staff believes that FASB's task force members also suggesting that *"predictability"* is a most important characteristic for purposes of distinguishing items of information.

However, the staff also observes that such items could be distinguished with line items within components of a performance statement. That is, distinguishing between such items need not be the primary reason for distinguishing between components of a statement of financial performance. For example, a business activities versus financing activities cut is a functional or activity classification scheme that could be used with required distinctions within those components for items having different predictive characteristics. Primary components based on a core/no core distinction would seem more consistent with the above principle if the definition of no core rests primarily the notion that all of the items included in the component (whether operating or financing) are those that are not expected to recur for an extended interval of time.

Application of Guiding Principles

The staff of the IASB/ASB identified Principles 3 and 1 as basis for making two primary distinctions for components of a performance statement. Those principles are:

Principle 3 – When current values are used to measure assets and liabilities, income and expenses can be divided between those resulting from economic activities of the period and revisions to estimates of future economic activity.

Principle 1 – A performance statement should be able to distinguish the return on total capital employed from the return on equity.

Principle 3 is used as the basis for distinguishing economic activity of the period form revisions to expectations of future economic activity.

The purpose of the distinction is to help users identify separately the performance of the current period that can be used to extrapolate future performance from value changes that are not directly useful in making predictions because they are derived form revised expectations of future performance. Principle 1 is used as the basis for distinguishing between operating and financing activity, which is accomplished by presenting all items of operating activity first followed by all items of financing activity.

The IASB/ASB staff suggests that the order three performance reporting principles can be applied in determining additional desegregations within the four main components.

Those principles are:

Principle 2 – Components of gains and losses should be reported gross unless they give little information with respect to future income.

Principle 4 – a performance statement should identify gains and losses where the change in economic value does not arise in the period in which it is reported.

Principle 5 – Within the prescribed format and without the use of proscribed subtotals, the performance statement should allow reporting in the form of:

- ✓ Information on the entity as a whole, analyzed by nature or function;
- ✓ The activities in disaggregated by business segments (geographic or product-based);
- ✓ Additional distinctions according to managerial discretion.

Evolution of comprehensive income

As early as 1936, arguments were made to support the all-inclusive or *"clean surplus"* concept, in which the income statement contains all changes in equity except for investments and dividend distributions.

In *"Introduction to Corporate Accounting Standards" (1940),* Patton and Littleton state: irregular factors – should be reported in the *"All determinants of income in the broadest sense – including unusual and* i*ncome statement before the net results are passed to the stock-equity section of the balance sheet".*

In *Accounting Research Study 3 (1962),* Sprouse and Moonitz state that *"the net profit (earnings, income) of a business enterprise during any given period of time is the amount of the increase in the owners' equity, assuming no changes in the amount of invested capital during the period either from price-level changes or from additional investments and no distributions of any sort to the owners."*

In 1966, *APB Opinion 9, Reporting the Results of Operations*, again emphasized the all-inclusive approach. The APB concluded that all changes recognized during the period should be reflected in the income statement, with the sole exception of adjustments of the income in prior periods. The APB later reaffirmed the all-inclusive approach in *APB Opinion 20, Accounting Changes*, and in *APB Opinion 30, Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business and Extraordinary, Unusual and Infrequently Occurring Events and Transactions.*

The concept of *"comprehensive income"* was first introduced in 1980 in *Statement of Financial Accounting Concepts 3* (superseded and replaced with Concepts Statement 6), *Elements of Financial Statements.*

Comprehensive income was defined as *"all changes and equity during a period except those resulting from investments by owners and distributions to owners."*.

FASB has defined comprehensive income broadly, so that many items currently excluded from income determination could eventually be included. For example, appreciation in the valuation of plant assets could at some point be included in comprehensive income. SFAS 130, however, does not include any item that does not currently appear as owner's equity.

Net income, as traditionally measured, continues to be reported in the income statement. Comprehensive income, consisting of *"traditional"* net income and other comprehensive income components, is displayed with prominence in the financial statements in one of three formats combined with the income statement (one-statement approach); as a separate statement (two-statement approach); or included in a statement of changes in stockholder's equity.

Time for a change: a proposal

Although one of the primary objectives of the income statement is to provide information to aid financial statement users in assessing future cash flows, the inclusion of the cumulative effect of a change in accounting principle in the income statement can be misleading in interpreting past results and is useless in predicting future cash flows.

The cumulative effect of a change in accounting principle is simply a book-keeping entry.

In addition to potentially misleading income statements, current GAAP permits inconsistencies because some exceptions go directly to retained earnings. With the availability of a comprehensive income statement, all changes in accounting principle should be shown as comprehensive income and omitted from the traditional income statement. This proposal would permit the comprehensive income statement to present an all-inclusive approach to comprehensive income, but would focus the traditional income statement on current operative performance.

The items currently considered as other comprehensive income are gains or losses that have not been realized and that may be offset in future years by other gains and losses. The cumulative effect of an accounting change is a one-time adjustment and will not be offset in future years. In addition, the cumulative effect is the result of income measurements and should ultimately be included in retained earnings. Consequently, the cumulative effect of accounting changes should be included in the comprehensive income statement and subsequently (the same statement) transferred to retained earnings.

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